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[BEFORE THE ARIZONA CORPORATION

COMMISSIONERS

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ORIGINAL**STAFF'S CLOSING BRIEF**

IN THE MATTER OF THE APPLICATION OF
 ARIZONA WATER COMPANY, AN
 ARIZONA CORPORATION, FOR A
 DETERMINATION OF THE FAIR VALUE OF
 ITS UTILITY PLANT AND PROPERTY AND
 FOR ADJUSTMENTS TO ITS RATES AND
 CHARGES FOR UTILITY SERVICE
 FURNISHED BY ITS EASTERN GROUP AND
 FOR CERTAIN RELATED APPROVALS.

I. INTRODUCTION.

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby responds to the Closing Brief submitted by the Residential Utility Consumer Office ("RUCO"). This matter came before the hearing officer as a result of the Commission's granting of RUCO's Application for Rehearing. The Commission reopened Decision No. 73736 and ordered a re-hearing of Decision No. 73938 for the purpose of reconsidering the legality of the System Improvement Benefits ("SIB") mechanism and the return on equity ("ROE"). All evidence and arguments previously made in this docket were specifically incorporated in this proceeding, and are before the hearing officer, and the Commission itself, for consideration of a final decision to be entered herein.

To a large extent, these issues were addressed in Staff's Closing Brief filed on April 29, 2013, following the hearing in Phase 2 of this case. Rather than repeat the contents of that Brief, Staff incorporates herein that Closing Brief, in particular, the following arguments:

1. The Commission should not be constrained from developing new ratemaking mechanisms in order to respond to ongoing regulatory challenges.¹
2. The proposed SIB comports with the Arizona Constitution.²
3. The proposed SIB provides an equitable balance between the interests of the utility and the ratepayers.³

¹ Staff's April 29, 2013 Closing Br. at 3.

² *Id.* at 4-9.

1 4. RUCO's objections to the SIB mechanism do not warrant rejection of the settlement
2 agreement.⁴

3 During the course of this proceeding, RUCO has asserted several theories as to why the
4 Commission should not have awarded the Arizona Water Company ("Company" or "AWC") both a
5 SIB and a 10.55 percent ROE. As discussed below, some confusion exists, based on the testimony at
6 the November 25 and 26, 2013, hearings, as to which of these theories RUCO continues to endorse.
7 Thus Staff will address each.

8 **II. NO ADJUSTMENT TO THE ROE IS WARRANTED BASED UPON THE**
9 **ADOPTION OF A SIB.**

10 During the Phase 2 portion of this case, RUCO asserted the theory that, given that a SIB (or
11 other DSIC-type mechanism) reduces the Company's risk, the Commission should reduce the ROE
12 whenever it awards a SIB.⁵ Based on its Closing Brief in Phase 3 (the Rehearing Phase), RUCO
13 appears to have retreated somewhat from that theory.

14 At hearing, RUCO's testimony on this issue was inconsistent. RUCO witness Ralph Smith
15 states, in summarizing his testimony, that "the implementation of a new tariff measure would
16 significantly reduce a utility's regulatory lag, reduces the utility's risk, and the reduction should,
17 therefore, result in a lower authorized return on investment."⁶ Yet upon extensive cross-examination
18 by Staff, Mr. Smith did not clarify and confirm this position.⁷ In contrast, RUCO witness David
19 Parcell clearly elucidated that he is not proposing a reduction in the Cost of Equity ("COE") to reflect
20 the SIB, but proposes a reduction because the Commission increased the COE to address
21 infrastructure replacement needs. Further, Mr. Parcell testified that a number of proxy companies
22 used by the cost of capital experts to determine the ROE had DSIC-like mechanisms in place,⁸ so any
23 associated reduction in risk was already considered in each expert's ROE recommendation.

24 RUCO contends that the ROE should be reduced when a SIB is granted. The problem RUCO
25 faces with its theory is that both of its expert witnesses, Ralph Smith and David Parcell, concede that,

26 ³ *Id.* at 9-10.

27 ⁴ *Id.* at 10-16.

28 ⁵ April 11, 2013 Tr. at 426-28, 488-90.

⁶ November 25, 2013 Tr. at 76-77.

⁷ *Id.* at 106-110.

⁸ *Id.* at 144-45.

1 while each believes a SIB reduces a company's risk, the reduction in risk cannot be quantified.⁹ If
2 the reduction in risk cannot be quantified, there can be no quantification of a corresponding reduction
3 to the ROE.

4 **III. THE RECORD IN THIS CASE DOES NOT SUPPORT A FIFTY-FIVE BASIS POINT**
5 **REDUCTION TO THE ROE BASED ON THE EXISTENCE OF THE SIB.**

6 RUCO next theorizes that, while the reduction in risk normally cannot be quantified, the
7 record here provides a proxy method for calculating that risk and the corresponding reduction to
8 ROE: namely that the Eastern Group's ROE was raised to 10.55 percent while the Western Group
9 was awarded a 10.0 percent ROE.¹⁰ Both Mr. Smith and Mr. Parcell rely on two assumptions: that
10 the ROE was increased from 10.0 to 10.55 and that the 10.55 was based on the SIB not being granted.
11 Both of these assumptions are without merit.

12 RUCO's assertion that the 10.55 percent ROE is unreasonably high given the granting of a
13 SIB is derived from a single sentence in Decision No. 73736, to wit: "Additionally, although our
14 decision in the 2012 Western Group Rate Case adopted a COE of 10.0 percent for the Western
15 Group, we conclude that the Eastern Group, due to the age of some of its systems and the resulting
16 increased need for infrastructure replacement and improvement, necessitates a somewhat higher
17 ROE."¹¹

18 The Decision consists of nearly 20 pages of analysis of the cost of equity issue and elucidates
19 numerous other factors on which it based its order, stating:

20 After considering all of the evidence presented in this case, including each party's
21 COE estimates and each party's criticisms of other parties' analyses and input data, we
22 conclude that the just and reasonable COE for the Eastern Group is 10.55 percent. In
23 addition to the parties' COE recommendations themselves, our decision has been
24 influenced by a number of other significant factors. For example, we are not
25 persuaded that AWC's location in Arizona or its size necessitates a 90-basis-point risk
26 premium, as Dr. Zepp asserted. Additionally, although our decision in the 2012
27 Western Group Rate Case adopted a COE of 10.0 percent for the Western Group, we
28 conclude that the Eastern Group, due to the age of some of its systems and the
resulting increased need for infrastructure replacement and improvement, necessitates
a somewhat higher COE.¹²

27 ⁹ *Id.* at 144-45.

28 ¹⁰ *Id.* at 90, 112.

¹¹ Decision No. 73736 at 61.

¹² *Id.*

1 It is clear from this language that the Commission at no time indicated that, absent the
2 infrastructure needs, the ROE would have been 10 percent or that it was increasing the ROE from
3 10.0 to 10.55. The reference to another of the Company's groups was only used as a comparison and
4 was only one of many factors.

5 Equally clear is that, in the Decision setting the ROE at 10.55 percent, the ROE was not set on
6 the basis that the DSIC-type mechanism was being denied or that the DSIC-type mechanism was
7 actually denied. To the contrary, the Commission explicitly anticipated that a DSIC-type mechanism
8 would be adopted at a later time in this proceeding. The denial of a SIB was merely the
9 recommendation of the Administrative Law Judge in her Recommended Opinion and Order
10 ("ROO"), a recommendation that was rejected by the Commission. A review of the transcript of the
11 February 20, 2013, Open Meeting at which the Decision was approved reveals that many of the
12 Commissioners were interested in the adoption of a DSIC-type mechanism.¹³ The Commission
13 adopted an amendment to the ROO, which deleted the portion of the ROO which analyzed and
14 rejected the proposed DSIC-type mechanisms, and instead inserted the following:

15 Although we will not authorize a DSIC herein, today, we are supportive of the DSIC
16 type mechanism and therefore we will leave this Docket open to allow the parties the
17 opportunity to enter into discussions regarding AWC's DSIC proposal and other DSIC
like proposals staff may wish to introduce....¹⁴

18 By rejecting the ROO's denial of a DSIC-type mechanism, the Commission clearly indicated that it
19 intended to adopt a DSIC-type mechanism to also address infrastructure needs when it adopted the
20 10.55 percent ROE.

21 **IV. THE SIB AND A ROE OF 10.55 PERCENT ARE NOT DUPLICATIVE.**

22 That both the SIB and the 10.55 percent ROE address the Company's failing infrastructure
23 does not, *per se*, make them duplicative or redundant. The Company presented uncontroverted
24 evidence of its aging and deteriorating infrastructure, including an in-depth report of the planned
25 plant replacements. The SIB surcharge will be limited to the projects detailed therein. Given the age
26 and extent of deterioration of AWC's plant, it is not unreasonable to expect that additional
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28 ¹³ February 12, 2013 OM Tr. at 36-37, 64-65, 67-68, 70.

¹⁴ Bitter-Smith Amendment No. 1, W-01445A-11-0310, February 12, 2013 OM.

1 infrastructure replacement will become necessary before the next rate case, but will not be included
2 in the SIB surcharge.

3 Even RUCO acknowledges that the SIB and a 10.55 percent ROE are not entirely duplicative.
4 Ralph Smith testified that the two are not “one hundred percent duplicative, but that, *conceptually*
5 there is *some* degree of duplication.”¹⁵ (Emphasis added). Similarly, while David Parcell also
6 believes there is some overlap, he concedes that the SIB and the 10.55 percent ROE could address
7 different plant.¹⁶ The most that can be concluded from the evidence is that it is conceptually possible
8 that there is some overlap, that it is possible that the SIB and the ROE could address different plant,
9 and that there is insufficient evidence to determine that the ROE and SIB are duplicative.

10 The SIB and the ROE also have different functions in addressing infrastructure replacement
11 needs. The Company presented testimony, through both Mr. Reiker and Ms. Ahern, that that the
12 purposes of the 10.55 percent ROE and the SIB are distinct. This testimony was uncontroverted.
13 The 10.55 ROE addresses the higher cost of equity that is required to fund the construction of
14 infrastructure replacement. The funds received through the SIB will fund the carrying costs or the
15 required annual return, together with related expenses.¹⁷

16 The Commission has many regulatory tools which it may use to assure that utilities provide
17 adequate service to their customers. Mr. Walker that testified, during the period from 2008 to 2010,
18 APS was awarded a higher ROE to address its financial needs and was also granted six different
19 adjustor mechanisms.¹⁸ As Mr. Walker noted in his testimony¹⁹ and as Staff stated in its April 29,
20 2013 Brief,²⁰ the Commission’s ratemaking authority is far from narrow and provides the
21 Commission with a variety of regulatory tools.

22 ...

23 ...

24 ...

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26 ¹⁵ November 25, 2013 Tr. at 119-120.

27 ¹⁶ *Id.* at 148.

28 ¹⁷ *Id.* at 162-63.

¹⁸ November 26, 2013 Tr. at 232-33.

¹⁹ *Id.* at 223.

²⁰ Staff’s April 29, 2013 Opening Br. at 3.

1 **V. A 10.55 PERCENT ROE WAS NOT OTHERWISE UNFAIR OR UNREASONABLE**
2 **IN THIS CASE.**

3 In Arizona, when the Commission sets an ROE, it does so on a case by case basis. Therefore,
4 any purported national trend toward a decline in ROEs is minimally relevant, at best; so, too, are the
5 ROEs of other companies. In this case, extensive evidence was presented during all hearing phases
6 to support rates of return that ranged from Staff's low of 9.1 percent ²¹ to the Company's high of 12.5
7 percent.²² RUCO and the Company both concede that the 10.55 ROE is within the range of those
8 requested by the Company and is supported by evidence presented in this proceeding.²³ Moreover,
9 there is nothing in the record that would support a finding that an ROE that is 55 basis points higher
10 than that now advocated by RUCO is unreasonable.

11 Even with the Commission's initial rejection of Dr. Zepp's proposed 90 basis point
12 adjustment, the Company's ROE would have been 11.6 percent. RUCO claims that the testimony of
13 Utilities Director Steve Olea supports a finding that the 10.55 percent ROE is unwarranted:

14 Q. (By Mr. Pozefsky) And in both the direct and the surrebuttal recommendations,
15 Staff rejected the company's 90 basis point premium risk request?

16 A. (By Mr. Olea) I will take your word for it.

17 Q. So assuming, subject to check, that that's correct, that Staff did reject it, if a 90
18 basis point risk premium is not warranted, would it also be logical to conclude
19 that a higher risk premium such as 115 basis points is similarly not warranted?

20 A. I would say yes, but I don't know how that's related to what we are talking
21 about, but yes, just on its face.

22 Q. On its face you would agree, correct?

23 A. Yes.²⁴

24 RUCO argues that, if a 90 basis point increase is unwarranted, so, too, is 115 basis point
25 increase from Staff's 9.1 to 10.55. As the question was posed, it called for a simple mathematical
26 comparison: if 90 is too high, then 115 is even higher. The question did not address the reason for
27 the adjustment, merely the numbers. In addition, Dr. Zepp's 90 basis point adjustment was a risk
28 premium. The characteristics of the 115 basis point reduction are not so clear.

²¹ Phase 1, Cassidy Dir. Test., Ex. S-5 at 43.

²² Phase 1 Zepp Dir. Test., Ex. A-32 at 6-8.

²³ November 25, 2013 Tr. at 111, 128, 210.

²⁴ November 26, 2013 Tr. at 265-66.

1 Contrary to RUCO's assertion, Staff does not contend that the Commission's discretion is
2 without limit; that would be unreasonable. The Commission must act in accordance with the Arizona
3 Constitution, statutes and case law. However, when setting an ROE, that discretion is broad.²⁵ So
4 long as the ROE awarded is supported by the evidence, the Commission's discretion will be upheld.²⁶
5 There is no dispute that such evidence was presented in this case.

6 **VI. THE SIB IS AN ADJUSTOR MECHANISM.**

7 Although the SIB possesses characteristics not found in a traditional adjustor mechanism, it is,
8 nonetheless, an adjustor mechanism. Rather than addressing an expense which fluctuates, a SIB
9 addresses capital costs which can be estimated during the rate case but which will change after the
10 rate case has concluded. The Commission has at times created novel and innovative adjustor
11 mechanisms. Testimony was presented by Paul Walker, on behalf of Global Utilities, that the
12 renewable energy surcharge, energy efficiency surcharge, energy efficiency demand-side
13 management surcharge, and environmental improvement surcharge are all adjuster mechanisms,
14 approved for APS.²⁷ RUCO witness Robert Mease acknowledged that RUCO had presented no
15 evidence to refute this.²⁸

16 RUCO, itself, acknowledges that an ACRM, which addresses a capital cost (not an expense)
17 that will be determined following the rate case, is an adjustor mechanism.²⁹ RUCO's attempt to
18 distinguish a SIB from an ACRM by virtue of the fact that the ACRM resulted from a federal
19 mandate does not support its position. In actuality, the federal mandate set a new arsenic standard for
20 water, which required water companies to construct additional plant to meet that standard. In order to
21 pay for that plant, the Commission approved the ACRM adjustor.³⁰

22 In this case, the Arizona Department of Environmental Quality has set standards for drinking
23 water in order to protect the public health.³¹ The Company presented sufficient evidence during
24

25 ²⁵ *Arizona Corporation Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); *Simms v. Round Valley Light and Power Co.*, 80 Ariz. 145, 294 P.2d. 378 (1956).

26 ²⁶ *State v. Tucson Gas, Elec. Light and Power Co.*, 15 Ariz. 294, 138 P. 781 (1914).

27 ²⁷ November 26, 2013 Tr. at 235.

27 ²⁸ November 25, 2013 Tr. at 22.

27 ²⁹ *Id.* at 24-25.

28 ³⁰ November 26, 2013 Tr. at 234-35.

28 ³¹ *Id.* at 239.

1 Phase 1 of this case to support a finding that, in order to meet these standards, it must replace aging
2 infrastructure on a large scale.³² Given the risk to the public health that can result from the numerous
3 line breaks described by the Company during Phase 1, the Commission's decision to establish a
4 mechanism to pay for additional plant to reduce or eliminate that risk is critical to meeting public
5 health and safety standards.

6 Moreover, even if the SIB were deemed not to be an adjustor mechanism, such a
7 determination would not cause the SIB to be illegal or unconstitutional. In the creation of the SIB,
8 numerous protections were included to assure compliance with Constitutional requirements. The SIB
9 proposed in the agreement has been developed in the context of a full rate case in which the
10 Commission has determined the Company's fair value rate base. The SIB will be limited to projects
11 that replace plant used to serve existing customers. The SIB further provides for the retirement
12 (removal from rate base) of the plant that has been replaced. Therefore, the new plant will not
13 generate a new revenue stream.

14 The SIB requires the Company to provide fair value information at the time that it seeks
15 Commission authorization to enact a SIB surcharge. This information will enable the Commission to
16 update the fair value rate base finding and to determine the impact of the revenues (with the addition
17 of the proposed SIB surcharge) on the Company's fair value rate of return. The SIB surcharge cannot
18 go into effect without a Commission order, and the agreement further provides that the Commission
19 may terminate the SIB at any time.

20 **VII. CONCLUSION.**

21 During each phase of this case, the entire record was available to the Administrative Law
22 Judge and to the Commission, so that in each Decision, all issues, including the ROE and the SIB,
23 were before them for consideration. It is clear that the Commission intended to adopt both a SIB and

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25 ...

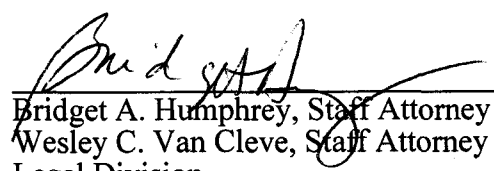
26 ...

27 ...

28 ³² Phase 1 Tr. at 472, 482-83, 483-87.

1 a 10.55 percent ROE. The Commission has great discretion to adopt rate-making tools and to set
2 rates. Here, there was evidence to support both, and the Commission properly exercised its discretion
3 in so doing.

4 RESPECTFULLY SUBMITTED this 17th day of January, 2014.

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